do not include losses on the sale of capital assets. That the Revenue Act of 1921 brought about a material change in computing the net income of life insurance companies has been recognized by this Court in the case of *New York Life Ins. Co.* v. *Bowers,* 283 U. S. 242, 248. See also dissenting opinion of Mr. Justice Brandeis in the case of *Nat'l Life Ins. Co.* v. *United States,* 277 U. S. 508, 523; *Massachusetts Mut. Life Ins. Co.* v. *United States,* 56 F. (2d) 897 (C. Cls.).

With this background, we come now to consider the single issue presented on this writ of certiorari.

THE AMOUNT OF INTEREST OWED TO THE RESPONDENT AND INCLUDED IN THE PURCHASE PRICE OF MORTGAGED PROPERTIES SOLD UPON FORECLOSURE PROCEEDINGS TO THE RESPONDENT CONSTITUTES TAXABLE INCOME

During 1930, the respondent acquired title to several pieces of property in Ohio and Michigan upon which it held mortgages and which it purchased at foreclosure sales. As the purchase price included in each instance the accrued interest in addition to the unpaid principal, the Board of Tax Appeals held that the amount of such interest constituted taxable income. The decision of the Board is in accordance with its rule long adhered to and applied in a number of other cases in which it passed on the issue presented here. See *Manomet Cranberry Co.* v. *Commissioner,* 1 B. T. A.

706, 709; *Reserve Loan Life Insurance Co.* v. *Commissioner,* 18 B. T. A. 359, 370; *Mac Lennan* v. *Commissioner,* 20 B. T. A. 900; *Missouri State Life Insurance Co.* v. *Commissioner,* 29 B. T. A. 401, affirmed, 78 F. (2d) 778 (C. C. A. 8th); *American Central Life Insurance Co.* v. *Commissioner,* 30 B. T. A. 1182.

In the instant case, however, the Sixth Circuit Court of Appeals declined to follow the rule adopted by the Board and also applied by the two other courts which have passed on this question. See *National Life Ins. Co.* v. *United States,* 4 Fed. Supp. 1000 (C. Cls.), certiorari denied, *sub nom. Lucey* v. *United States,* 291 U. S. 683; *Missouri State Life Insurance Co.* v. *Commissioner, supra.* The court below recognized that its decision was directly in conflict with the two just cited cases but refused to accept the reasoning of the courts in those two cases. It squarely held that neither in legal effect, nor in fact, did the respondent receive interest by the acquisition of the mortgaged properties at foreclosure sales on its own bids in amounts equal to the principal and unpaid interest.

The theory upon which the Commissioner has long included in gross income of life insurance companies accrued interest in such cases is probably best stated in the opinion of the Court of Claims in the *National Life Ins. Company* case, *supra.* In that case, as in this, the taxpayer had outstanding a number of mortgage loans on which

there had been default and, as here, it caused the mortgages to be foreclosed and the properties involved to be sold at public foreclosure sales. The taxpayer was the only bidder and in those States where the state law provided that the property might be redeemed by the mortgagor or junior lienholders, it bid the full amount of the unpaid principal and accrued interest due thereon up to the date of the sale, together with court costs and other charges. It was the taxpayer's contention that, under the language of the statute and regulations, the accrued interest in default did not constitute income received when the mortgaged properties were acquired because none of the interest was actually received during the taxable years, but the court did not agree. While the court admitted that the income of a life insurance company, under the statute, is to be computed on the basis of actual receipts and disbursements, it held that the interest had been received when the properties were acquired, and constituted taxable income. The court said (p. 1011):

> In its essence the transaction consisted of a judgment in favor of plaintiff and against the mortgagor for the principal indebtedness plus the accrued interest and a decree of foreclosure and sale of the properties given as security for such indebtedness and interest. * * * At these public sales plaintiff offered for the properties the full amount of the unpaid principal and accrued interest due it to the date of the sale, and the prop-

> erties were duly sold to plaintiff by the officer designated by the court to make the sale. This, in our opinion, established the market for these particular properties for the purposes of this case and is determinative of whether plaintiff received the interest in question.
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> Viewed in this light plaintiff actually received the interest due it. Inasmuch, however, as plaintiff was the purchaser of the properties under the sales there was no payment of money but the properties were deeded to plaintiff. There must have been, and doubtless were, circumstances which led plaintiff to believe that the acquisition of a complete and clear title to the properties was worth the amount of the unpaid principal and accrued interest to it. There was a consideration moving to plaintiff for its bid for the amount of the unpaid principal and accrued interest; such bid foreclosed the equity of redemption of the mortgagor or junior lienholder and precluded all further controversies that might have arisen had the property been bid in for a lesser sum and judgment taken against the mortgagor for the balance.

Likewise, the Eighth Circuit Court of Appeals, in *Helvering* v. *Missouri State Life Ins. Co., supra*, in passing upon precisely the same question, held (p. 780):

> When mortgaged property is sold on foreclosure for an amount sufficient to pay the

mortgage debt with accrued interest, the mortgagee has received payment in full of its debt, and that is so, regardless of whether the highest bidder at the sale is the mortgagee or a stranger. Where a stranger buys, he pays cash to the officer making the sale, who pays it to the mortgagee. Where the mortgagee buys the property, instead of paying cash to the officer and receiving it back, he credits the amount which he, as purchaser, bids, upon the mortgage debt. In either event, he receives payment in cash or its full equivalent.

In the case at bar, the respondent and the court below relied largely upon the fact that the so-called "fair market value" of the properties in this case was less at the time of acquisition than the unpaid principal of the loans. In this connection, it should be noted that it was the respondent here which set the amount of the bids and made the bids large enough to include accrued interest, as well as unpaid principal. It did this as a protection to itself in case the mortgagor attempted to secure the property during the period of redemption. In other words, it secured a benefit by fixing the purchase price at these sales. Accordingly, having served its own purposes, it should not now be allowed to escape the burden which follows such action but should be required to pay the tax on the interest which it included in the purchase price, regardless of what might be said to be the "fair market value" of these properties to others.

We are of this opinion because it is not open to question that a valid, binding, and enforceable liability for the bid price is created as soon as mortgaged property is struck off to a successful bidder at the foreclosure sale. Likewise, the respondent in this case incurred by its bid an enforceable liability equal to the price which it offered when the respective mortgaged properties were knocked down to it by the sheriff or other officer conducting the sale. *National Life Ins. Co.* v. *United States, supra; Strother* v. *Wilkinson,* 108 Okla. 57; *Andrews* v. *O'Mahoney,* 112 N. Y. 567.

As a general rule, an officer selling property under a decree of foreclosure has no authority to sell or credit or to accept as payment on bid prices anything other than lawful money, unless otherwise expressly authorized by the terms of the decree or the law in force governing the sale. Where the creditor becomes purchaser of the mortgaged property, it is usually considered a sufficient compliance with the requirements of a sale for cash that the amount of the bid be credited on the mortgage debt and the judgment for the indebtedness is fully satisfied to the extent of the amount paid by the creditor. Freeman on Judgments, 5th Ed., Vol. 2, p. 2371; *Walker* v. *Powers,* 104 U. S. 245; *Lockwood* v. *Cook,* 58 Neb. 302.

When the respondent bid in the mortgaged property, it became a purchaser and its title and rights in, and to, such properties were precisely the same

as if it had been a stranger to the mortgages. The fact that the respondent was not only the purchaser but also the mortgagee is without legal significance. The mortgagee acquires the same right and interest in the property sold as any other person would, no more, no less. The only advantage the mortgagee has is that to the amount of the judgment in its favor it is not obligated to make actual payment of the purchase price, for to that extent its bid is payment on its debt. *Ledyard* v. *Phillips,* 47 Mich. 305; *Avon-by-the-Sea Land & Improvement Co.* v. *Finn,* 56 N. J. Eq. 808; cf. *Baird* v. *Northern Savings Bank,* 56 N. D. 811

Accordingly, on the acquisition of these properties, the respondent here entered into possession thereof, not as a mortgagee but as a purchaser. *Belter* v. *Lyon,* 102 N. Y. 725, 7 N. E. 821. It paid either cash or the equivalent of cash by crediting the amount of its bids against the mortgagor's indebtedness, thereby releasing and extinguishing the latter's liability to the extent of the proceeds of the foreclosure sales applicable to the mortgage debts. Such transactions were no different than if the respondent had paid to the officers making the sales the full amounts of its bids and such officers had thereafter returned the money to the respondent in payment of the unpaid principal and accrued interest. In legal effect, this is the result of the transactions by which the respondent acquired title here, and to the extent of the accrued interest the respondent realized taxable income.

The fact that the accrued interest was not entered on the books of the respondent as income is not material because it is well established that bookkeeping entries are not conclusive. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71. Bookkeeping records alone will not justify a taxpayer in claiming an exemption. It is the real facts and not such records which must control in determining net income. *Southern Pacific R. Co.* v. *Muenter*, 260 Fed. 837 (C. C. A. 9th); *Chattanooga Sav. Bank* v. *Brewer*, 9 F. (2d) 982 (E. D. Tenn.).

Also the possibility that a mortgagee, who becomes the purchaser of mortgaged property by bidding it in for the amount of the principal and accrued interest, may sustain a loss on a future disposition of the property is of no controlling importance in determining whether such mortgagee received such interest as taxable income. The future disposition of the property is necessarily an entirely different transaction. Moreover, while a loss cannot be deducted by a life insurance company, it is also true that any profit which might be made on a future sale cannot be treated as interest on the loan, and is not even taxable, and inasmuch as it cannot be classified as interest, dividends, or rent, it does not come within the statutory provision describing taxable income for life insurance companies. See Section 202, Revenue Act of 1928, and Article 961, Regulations 74, *infra*.

So, we submit, it is immaterial that the fair market value of the properties acquired by the respondent may have been less than the consideration which the taxpayer was willing to pay in order to acquire title to these properties. *National Life Ins. Co.* v. *United States, supra; Missouri State Life Insurance Co.* v. *Commissioner, supra.*

If the fair market value of the property be material, we think it quite plain that, under the circumstances here, the taxpayer has received something of exchangeable value, in an amount equal to the unpaid principal and accrued interest. This being true, the treatment of such property by the Commissioner as the equivalent of a cash payment is in accordance with the definition of income approved by this Court. *Eisner* v. *Macomber,* 252 U. S. 189. There, this Court held that income may be derived from "something of exchangeable value proceeding from the property" (p. 207). Here, we have properties acquired by the taxpayer at a value which included the accrued interest. As pointed out above, the bid in this amount was for the purpose of foreclosing the mortgagor from redeeming the property at any figure less than the principal of the debt plus accrued interest. The taxpayer, in thus protecting himself, fixed the amount which the mortgagor would be forced to pay in order to redeem the property. As between the parties the value of the property was set at a

figure which included interest. The taxpayer was unwilling, during the taxable period, that these properties should go to another at less than the amounts bid. This is the significant and controlling factor, we submit, which sets the "exchangeable value" of these properties at a figure which includes accrued interest and thus meets the accepted definition of taxable income. It is not material for present purposes, of course, that these properties may thereafter be sold at a net gain or loss to the taxpayer. The Federal revenue laws relating to income taxes are based upon an annual accounting period and the receipt of income is computed upon the net result of all transactions within the year. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359.

The court below was of the opinion that, because the taxpayer was the mortgagee and allowed to set off against the bid price the amount of his debt, the instant case is wholly different than if the respondent had received full cash payment. (R. 20.) We submit that this distinction is not vital when it is realized the taxpayer received, instead of cash, property of an equivalent value. To deny it such equivalent value is to disregard the actual fact, as shown by the taxpayer's voluntary bid at a public sale, that the property in question was worth, to the respondent, the full amount of its unpaid principal and accrued interest. Accordingly, it is submitted, the property received may properly, with-

out resort to the doctrine of constructive receipt, be treated as cash to the extent of its value, and the interest which the taxpayer is required to include in income is not restricted to cash receipts bearing the label of interest. *American Central Life Ins. Co.* v. *Commissioner*, *supra*, p. 1190.

Even in cases where the taxpayer itself has advanced funds for the payment of interest on obligations which it owns, the courts have held that the return thereof to the taxpayer constitutes taxable income. In *American Cigar Co.* v. *Commissioner*, 66 F. (2d) 425 (C. C. A. 2d), certiorari denied, 290 U. S. 699, interest on bonds was paid from funds advanced for that purpose by the taxpayer, a large stock and bond holder of the debtor corporation. The advances were made for operating expenses and the payment of interest upon the bonds, because the taxpayer corporation was reluctant to have the debtor placed in receivership. As here, the taxpayer was doing something to protect its own financial interests. The court held that although the interest received was from funds advanced by the taxpayer, that fact could not alter the character of the interest and its taxability as such. A like result was reached by the Circuit Court of Appeals for the Fourth Circuit in *Duke Power Co.* v. *Commissioner*, 44 F. (2d) 543, 545, certiorari denied, 282 U. S. 903, a case involving similar circumstances, because "Interest, by the very terms of the act, is made income, and is tax-

able." So, we submit, it is not necessary that interest received, to be taxable, must reflect a clear gain or profit on invested capital; but where, as here, property is received of the equivalent value of a cash payment of the interest, the statute requires that, to such extent, interest be included in the gross income of the recipient. See *Eisner* v. *Macomber, supra.*

If insurance companies are permitted to bid in mortgaged properties at amounts which will protect the accrued interest as well as the principal in case of redemption, to carry these properties on their books at figures which do not reflect the receipt of such interest, and in later years to sell the properties for enough or more than enough to offset both unpaid principal and accrued interest, an avenue is open for the escape in substantial amounts of one of the principal sources of their taxable income. This is true because the statute taxes only interest received during the taxable year and at no time taxes the gain upon capital assets. We submit that Congress, having already provided for special and privileged treatment of the taxable income of life insurance companies, different from that of other corporations and individuals, never intended that property bid in or purchased by an insurance company at one value should be accorded another and lower value for income tax purposes.

CONCLUSION

In view of the foregoing, we respectfully submit that the decision of the Circuit Court of Appeals should be reversed.

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NOVEMBER 1936.

APPENDIX

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 201. TAX ON LIFE INSURANCE COMPANIES.

* * * * *

(b) *Rate of tax.*—In lieu of the tax imposed by section 13, there shall be levied, collected, and paid for each taxable year upon the net income of every life insurance company a tax as follows:

(1) In the case of a domestic life insurance company, 12 percentum of its net income;

* * * * *

SEC. 202. GROSS INCOME OF LIFE INSURANCE COMPANIES.

(a) In the case of a life insurance company the term "gross income" means the gross amount of income received during the taxable year from interest, dividends, and rents.

* * * * *

Treasury Regulations 74:

ART. 193. *Uncollectible deficiency upon sale of mortgaged or pledged property.*—Where mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the mortgagee or pledgee ascertains that the portion of the indebtedness remaining unsatisfied after such sale is wholly or partially uncollectible, and charges it off,

he may deduct such amount (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it is ascertained to be wholly or partially worthless and charged off. In addition, where the creditor buys in the mortgaged or pledged property, loss or gain is realized measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by him) and the fair market value of the property. The fair market value of the property shall be presumed to be the amount for which it is bid in by the taxpayer in the absence of clear and convincing proof to the contrary. If the creditor subsequently sells the property so acquired, the basis for determining gain or loss is the fair market value of the property at the date of acquisition.

Accrued interest may be included as part of the deduction only when it has previously been returned as income.

ART. 951. *Life Insurance companies.*— Life insurance companies, as defined in section 201 (a), are subject to the tax imposed by section 201 (b), in lieu of the tax imposed by section 13. The rate for 1928 and for subsequent years is 12 per cent, and the net income upon which the tax is imposed differs from the net income of other corporations. Insurance companies are entitled to the benefit of section 117 (net losses) but not of section 101 (capital gains and losses). All provisions of the Act and of these regulations not inconsistent with the specific

provisions of sections 201–203 are applicable to the assessment and collection of this tax, and life insurance companies are subject to the same penalties as are provided in the case of returns and payment of income tax by other corporations. In determining whether an insurance company is a "life insurance company" as defined in section 201, no reserve shall be regarded as held for the fulfillment of life insurance and annuity contracts unless the company is entitled to a deduction from gross income on account thereof under the provisions of section 203 (a) (2) and article 971. As to foreign companies, see section 203 (c) and article 977.

ART. 961. *Gross income of life insurance companies.*—Gross income in the case of life insurance companies means the gross amount of income received from interest, dividends, and rents, and comprises items 25–34 of the income page of the annual statement for life insurance companies (edition of 1920) adopted by the National Convention of Insurance Commissioners and items 23–30 of the income page of the annual statement for miscellaneous stock companies if any other branches of the insurance business are conducted by the company; except that the rental value of the space occupied by the company in its own building or buildings if included in gross income shall be determined according to the provisions of section 203 (b) and article 976. As to "reserve funds required by law", see article 971.

U. S. GOVERNMENT PRINTING OFFICE: 1938